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Classified By: Economic Counselor David R. Burnett; reasons 1.4 b/d

11. (S/NF) Summary: In February 16-17 meetings, Senior Shin Bet officials outlined for Emboffs their views on recent trends in the Gaza Strip's economy, including the paradoxical effect of "clean" Palestinian Monetary Authority (PMA)-regulated banks serving Hamas interests, the operating dynamics of a market split between legitimate and illicit activity, and the growing economic division between Gaza and the West Bank. The legitimate market sector, anchored by the PMA-regulated private banking system is mirrored by an alternative Hamas financial system, both of which are linked by currency flows and trade. End Summary.

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The PMA-regulated private banking system  
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12. (S/NF) The PMA-regulated private banking network provides the backbone for the legitimate sector of Gaza's market. Salaries paid by the Palestinian Authority, international aid, and legitimate trade finance all flow through these banks. New Israeli Shekels (NIS) and U.S. Dollars (USD) comprise the majority of hard currency transfers. The private banks that operate under PMA-supervision are well-regulated according to PMA-prescribed Anti-Money Laundering legislation. According to Shin Bet, suspicious activity is usually reported, and Hamas has been unable to make any significant inroads in bank activities. The banks have maintained their independence from the Hamas regime with the threat that they will close if Hamas attempts infiltration. The banks will not let Hamas operatives open bank accounts or have their salaries deposited in any existing accounts. Shin Bet has not seen any attacks on the banks by Hamas-affiliated groups or individuals.

13. (S/NF) However, Shin Bet officials assess that Hamas is significantly benefiting from the PMA-regulated banks, even though they do not directly utilize them for commercial activity. These well-operated banks, which are "clean" of money-laundering or terror finance, provide the non-Hamas population of the Gaza Strip with a key financial service that improves their quality of life. Shin Bet believes that due to a lack of successful strategic messaging by the PA and PMA that makes clear how they--and not Hamas--are providing these private banks as a public service, Hamas has been able to take full credit. Hamas has led the Gaza population to believe that it is their leadership which has enabled these banks to function relatively effectively and without corruption. As such, even though they are not under Hamas control, the PMA-regulated private banks support Hamas because they provide a necessary financial service at no cost

to the Hamas regime. Shin Bet argues that this is why the banks' threats of closure have proven effective against Hamas encroachment.

¶4. (S/NF) Shin Bet also believes that the private Palestinian banks operating branches in Gaza would prefer to close them due to low profitability relative to risk. Political considerations and pressure from the PA, PMA, and others, are the primary reason why they remain in operation. While Shin Bet faults the PA for not getting more street credit for the Gaza banking system, they agree that a pull-out by the banks would be a political and psychological blow to the PA.

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The Hamas Alternative Financial System  
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¶5. (S/NF) A Hamas alternative financial system exists parallel to the PMA-regulated banking system. Hamas smuggles in large quantities of foreign currencies (primarily USD and Euros) in order to fund its operating expenses. According to Shin Bet, their budget consists of three major parts: 1) USD 200 million annually for government operating expenses; 2) USD 50 million each year to support the Hamas movement's civilian side and organization; and, 3) USD 40 million annually for its military wing and security apparatus. Over the past several months, shortages of cash for Hamas salary payments (usually made in USD) have been reported (see REFs A and B). Shin Bet now believes that this was due primarily to Israeli efforts to thwart terror funds and Egyptian counter-smuggling operations, not a lack of actual funding from abroad. Recently, however, Hamas has adapted to this

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crackdown and re-rerouted its smuggling operations, bypassing Cairo and heading directly through Sinai, thereby more easily evading detection. They have also reduced the size of amounts smuggled into Gaza at one time to avoid large losses after any one interdiction. Shin Bet also notes dwindling levels of support from the Egyptians in stemming this flow of funds. Additionally, Hamas has increased tax collection, as detailed in REF A.

¶6. (S/NF) With these modifications, the parallel economy has been flourishing, and the delayed salary payments are not symptomatic of a more endemic problem. Hamas has also established a second branch of its own National Islamic Bank in Khan Yunis, and is attempting to initiate correspondent relations abroad. Shin Bet reiterated the importance of a timely U.S. designation of the Hamas "bank" to prevent this from happening, given that it would significantly increase the ease by which Hamas could receive and transfer funds. Hamas also continues to receive funding from Iran.

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Overall Gaza Market Dynamics  
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¶7. (S/NF) These parallel dynamics lead to an overall Gaza economy based on imports from Egypt through the smuggling tunnels, paid for in foreign currency--not Israeli shekels. There has been a steady influx of shekels -- mostly from PA salary payments into Gaza -- with limited outbound circulation. Instead, these shekels are used predominately for internal exchange. Under the PMA-regulated private banking system, individuals are paid in NIS from the Palestinian Authority. Local merchants conduct their business with the average Gazan in NIS, who in turn use NIS for most of their daily purchases. However, in order to procure non-Israeli imports (through the smuggling tunnels), the local merchants are required to convert these NIS into USD, since the exporters from Egypt and elsewhere operate primarily in USD. This results in a large amount of outgoing foreign currency for imported goods, while an insignificant amount of shekels leave the Gaza market due to the near complete lack of trade with Israel (and, to a lesser degree,

the West Bank). When combined with Israel's restrictions on the transfer of hard currency both into and out of Gaza, this has led to a surplus of shekels and deficit in foreign currencies (including USD and Jordanian Dinars), which has allowed speculators (including Hamas, merchants and banks) to exploit the system and profit from arbitrage.

18. (S/NF) In the long run, Shin Bet assesses that these currency imbalances destabilize Gaza's economy and will lead to pendulating NIS/USD exchange rates, the result of intermittent incremental changes in currencies permitted in and out by Israel, variation in the quantities and types of currencies smuggled into Gaza, and incentives to exploit systemic changes through arbitrage. They are concerned that there will be an eventual shift from the current mixed currency system, dominated by NIS, to sole use of foreign currency (likely USD). Local merchants have already attempted to require that Gazans pay for goods in USD or other foreign currencies, to minimize exchange-rate losses when they are forced to exchange the shekels for dollars or other foreign currencies, whether through the banking system or through the Hawala (money-changers), to purchase restock imported inventories. Because of the current shortage of USD in the banking system, Gazans have been unable to oblige and the local merchants have relented, according to Shin Bet analysts. Israel's policy, per the Paris Protocol, is to maintain use of shekels in the Palestinian territories, and the GOI worries that if the shift to a non-shekel economy in Gaza takes place, it will further solidify the separation of Gaza from the West Bank.

19. (S/NF) From a counter-terrorism perspective, Shin Bet sees less of a security threat from a shekel-based Gaza economy than a foreign-currency-based Gaza. It sees no direct security threat from excess shekels in Gaza. Shin Bet analysts have not seen any attempts to rob banks vaults, nor are they concerned that Hamas or others could use shekels to purchase any materials from abroad that could be used for terrorism (given that they would have to be exchanged first for currently lacking foreign currencies). Given the separation between Hamas and the PMA-regulated private banks, Shin Bet assesses there to be little connection between these banks' stability and Israel's counter-terrorism goals. In the short-term, security concerns from a decrease in confidence in these banks by average Gazans is negligible for

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Israel. However, in the long-run, Shin Bet officials conceded that it is important to preserve these institutions as one of the few alternatives to Hamas in the Gaza Strip, and as a foundation for economic stability in Gaza.  
Cunningham